

**IT 98-4**

**Tax Type: INCOME TAX**

**Issue: Financial Organization(s) (Credit Card Banks)  
Audit Methodologies and/or Other Computational Issues  
Replacement Tax Investment Credit/Property Used In Retailing**

**STATE OF ILLINOIS  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE HEARINGS DIVISION  
CHICAGO, ILLINOIS**

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<b>THE DEPARTMENT OF REVENUE</b>	)		
<b>OF THE STATE OF ILLINOIS,</b>	)		<b>No.</b>
<b>Petitioner</b>	)		
	)		
<b>v.</b>	)		<b>FEIN:</b>
	)		
<b>THE XYZ ) Linda K. Cliffl</b>			
<b>COMPANY,</b>	)		<b>Administrative Law Judge</b>
<b>Taxpayer</b>	)		

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**RECOMMENDATION FOR DISPOSITION**

**APPEARANCES:** Richard Lipton and Jane May of Sonnenschein Nath & Rosenthal for The XYZ Company; Robert C. Asbille, Special Assistant Attorney General, for the Illinois Department of Revenue.

**SYNOPSIS:**

On December 23, 1994 the Department of Revenue issued a Notice of Deficiency for the years ended January 27, 1990, February 2, 1991 and February 1, 1992 for additional tax and penalties of \$3,593,406. This Notice was protested by the taxpayer on February 21, 1995. This cause was consolidated for hearing with Docket No., a related taxpayer, for hearing.

There were three issues argued at hearing: first, whether the Department correctly included the "credit card banks" in the XYZ COMPANY unitary business group; second, whether a sale-leaseback is a disposition for purposes of investment tax credit recapture; and

third, whether the Section 1005 penalties should be abated due to reasonable cause. Subsequent to hearing, legislation passed which defines a financial organization, and consequently the Department concedes the credit card bank issue.

The taxpayer also filed a Protest Act case in Sangamon County on several issues for the tax years 1988 and 1989 which are the same as issues herein. The parties agreed to be bound by the final outcome in that case, No. 93-TX-10, in regard to the inclusion of XYZ FUNDING, Inc. and The XYZ COMPANY Credit Corp. in the XYZ COMPANY unitary business group. The parties have reached a final settlement in that case, and therefore, the treatment of XYZ FUNDING and XYZ CREDIT CORP. will be the same as in that settlement.

The treatment of additional issues relating to the addition of certain items listed on Schedule J, the inclusion of service charge income in the sales factor and the disallowance of investment tax credits were stipulated to by the parties and that stipulation is incorporated herein.

On consideration of these matters, it is recommended that the credit card bank issue be resolved in favor of the taxpayer, the investment tax credit issue be resolved in favor of the Department, and the §1005 penalties be abated.

#### **FINDINGS OF FACT:**

1. ABC STORES, INC. ("ABC") is part of the XYZ COMPANY unitary business group in 1990 and 1991. (Dept. Ex. No. 1)
2. On May 18, 1990, as part of an arms-length third-party sale-leaseback transaction (hereinafter "sale-leaseback"), ABC sold thirty of its seventy-three store real estate properties and one warehouse property to FICTITIOUS Life Insurance Company ("FICTITIOUS") and simultaneously leased back the properties. (Stipulation - Recapture Issue ¶6)

3. Eighteen of the properties involved in the sale-leaseback are located in Illinois. Seventeen of the properties were owned by ABC and the transfer was accomplished by means of a deed, and one property located in Fairview Heights, Ohio was ground-leased by ABC and the transfer was accomplished by means of an assignment of the ground lease. (Stipulation - Recapture Issue ¶7)
4. Taxpayer claimed Illinois Investment Tax Credits ("ITC") and Enterprise Zone Credits ("EZC") on these assets. (Stipulation - Recapture Issue ¶8)
5. The properties subject to the sale-leaseback are used by ABC in exactly the same manner and for the same purposes after the sale-leaseback as immediately before. (Stipulation - Recapture Issue ¶9)
6. For federal tax return purposes, taxpayer was not required to recapture any tax credits. (Stipulation - Recapture Issue ¶10)
7. The Lease Agreement between FICTITIOUS and ABC ("Lease") provides for an initial lease term of 20 years. (Stipulation - Recapture Issue, Exhibit E, F, pp. 4, 5) The Lease provides for four optional renewal terms of 5 years. (Stipulation - Recapture Issue, Exhibit E, F, Article XIX)
8. Article III of the Lease provides for the payment of taxes by the Lessee. Article IV of the Lease provides that repairs and maintenance of the properties is the responsibility of the Lessee. Article VI provides that the Lessee will pay for insurance on the properties. (Stipulation - Recapture Issue, Exhibit E, F)
9. Taxpayer consulted competent outside counsel for his opinion on whether recapture was required, and taxpayer based its tax return position on his advice. (Tr. pp. 94-98)

## **CONCLUSIONS OF LAW:**

### **1. Recapture**

ABC entered into sale agreements and lease agreements with FICTITIOUS whereby ABC sold certain store locations to FICTITIOUS and simultaneously leased them back. ABC continued to use the properties in the same manner after the sale-leaseback as it did before.

There was no dispute regarding whether the properties qualified for the investment tax credit originally. The Department in this audit, however, has taken the position that the sale-leaseback of these properties is a disposition and therefore triggers recapture.

The taxpayer argues that the use of the properties has not changed as a result of the sale-leaseback, and further, that under federal tax law, no investment tax credit recapture is triggered.

Section 201(e) of the Illinois Income Tax Act<sup>1</sup> defines qualified property for purposes of the investment tax credit. Qualified property means property which:

- A) is tangible, whether new or used, including buildings and structural components of buildings;
- B) is depreciable pursuant to Section 167 of the Internal Revenue Code...
- C) is acquired by purchase as defined in Section 179(d) of the Internal Revenue Code;
- D) is used in Illinois by the taxpayer in manufacturing operations or in mining coal or fluorite, or in retailing; and
- E) has not previously been used in Illinois in such a manner and by such a person as would qualify for the credit provided by this subsection (e) or subsection (f).

According to Section 201(e)(7),

If during any taxable year, any property ceases to be qualified property in the hands of the taxpayer within 48 months after being placed in service, or the situs of any qualified property is moved outside Illinois within 48 months of being placed in service, the Personal Property Tax Replacement Income Tax for such taxable year shall be increased....(emphasis added)

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<sup>1</sup> Unless otherwise noted, reference to sections are to the Illinois Income Tax Act, 35 ILCS 5/101 et seq.

The issue here, then, is whether a sale-leaseback causes property to cease to be qualified for purposes of the investment tax credit. According to departmental regulations at 86 Admin. Code ch. I 100.2100(f)(1), "Any property disposed of by the taxpayer within 48 months of being placed in service ceases to qualify." Regulation Section 100.2100(f)(2) states:

A taxpayer disposes of property when he sells the property, exchanges or trades in worn-out property for new property, abandons the property or retires it from use. Property destroyed by casualty, stolen, or transferred as a gift is treated as having been disposed of. Property which is mortgaged or used as security for a loan does not cease to qualify provided the taxpayer continues to use the property in its business within Illinois....

Nowhere in the Illinois statutes or regulations is a sale-leaseback specifically dealt with. According to the regulations, a "disposition" will trigger recapture. In the case here, the taxpayer sold its real estate interests in thirty stores, simultaneously leased the premises back from the purchaser, and continues to use the property in the same manner as before the sale.

Taxpayer points to Treas. Reg. §1.47(3)(g)(1) of the federal income tax regulations which deals specifically with sale-leasebacks:

Notwithstanding the provisions of §1.47-2, relating to "disposition" and "cessation", paragraph (a) of §1.47-1 [relating to recapture] shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands....

Although the Illinois law relating to the replacement tax investment credit does make reference to various provisions of federal law, it does not track precisely the federal investment tax credit provisions. For example, for federal purposes, recapture is calculated on a sliding scale: 100 percent of the credit is recaptured if the property is disposed of within one year of being placed in service, to 20 percent of the credit if the property is disposed of within 5 years (for property with a useful life greater than 3 years). Internal Revenue Code §47(a)(5)(B). For

Illinois purposes, on the other hand, the full amount of the investment credit is recaptured if the property is disposed of at any time within the 48-month period. Also, treasury regulations exempt dispositions of property due to casualty from the recapture rules (Treas. Reg. §1.47-3(c)), while according to Regulation Section 100.2100(f)(2), for Illinois purposes, property destroyed by casualty is treated as having been disposed of.

Taxpayer raises §102 of the IITA (35 ILCS 5/102) to support its position that federal tax law should control. Section 102 provides as follows:

Construction. Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act, shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year.

Taxpayer argues that the term “disposition” should be given the same meaning here as is given by Treas. Reg. §1.47-3(g), and that sale-leasebacks are therefore excluded from dispositions.

From a statutory construction viewpoint, however, there is no ambiguity here, and the plain meaning of the statute must control. There is no dispute that taxpayer sold its properties. Clearly a sale is a disposition. 86 Admin. Code ch. I, 100.2100(f)(2). Taxpayer wishes to incorporate federal tax treatment of sale-leasebacks into Illinois law by reference to §102. However, in the absence of specific language excluding sale-leasebacks from “dispositions,” a sale is a sale and must be treated as one.

Taxpayer also argues that the sale-leaseback is nothing more than a financing transaction. However, for a number of reasons, the taxpayer has failed to show this to be a fact. To begin, if we look to the incidents of ownership held by each party, the purchaser of the property received legal title while the taxpayer retains the use of the property by means of a lease. Taxpayer

argues that ABC has the following incidents of ownership: it operates the property, pays taxes and pays utilities.<sup>2</sup> However, these are precisely the obligations of a lessee under a net lease,<sup>3</sup> and therefore does not further taxpayer's position.

Further, for financial accounting purposes<sup>4</sup> as well as federal income tax purposes,<sup>5</sup> one indication that a sale-leaseback is merely a financing transaction is that the lessee has the use of the property for substantially its entire useful life. Here, the lease has an initial term of twenty years with options to extend for four five-year periods. No evidence was introduced by taxpayer regarding the useful life of the properties.

Another indication that a sale of property is not a true sale is that the legal ownership of the property is transferred at the end of the lease to the seller/lessee, or that the lease provides for a bargain purchase option (the purchase price to the lessee at the end of the lease term is significantly below market value). The lease here had no such provisions.

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<sup>2</sup> Taxpayer also argues that one of the incidents of ownership is the retention of the federal investment tax credits. This, of course, is precisely the issue here: Does Illinois law track federal law regarding investment credit recapture in a sale-leaseback transaction?

<sup>3</sup> Black's Law Dictionary. "Net lease" is defined: "Lease in which provision is made for the lessee to pay in addition to rent, the taxes, insurance and maintenance charges."

<sup>4</sup> Statement of Financial Accounting Standards No. 13 Accounting for Leases ("SFAS"). If a lease meets any one of the four criteria, the seller/lessee should report it as a capital lease.

1. The lease transfers the asset to the lessee by the end of the lease period.
2. The lease contains a bargain purchase option
3. The lease term is equal to or greater than 75% of the estimated economic life of the asset.
4. At the beginning of the lease, the present value of the minimum lease payments equals or exceeds 90% of the fair market value of the leased property.

<sup>5</sup> See Rev. Proc. 75-21, 1975-1 C.B. 715 as modified by Rev. Proc. 76-30, 1976-2 C.B. 647. Federal case law as to the weight to be given of the various indicia of ownership are not conclusive. See, e.g. Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (sale-leaseback is a true sale); Sun Oil v. Commissioner, 562 F.2d 258 (3d Cir. 1977) (sale-leaseback is a financing transaction).

The evidence introduced shows that, in fact, there was a real transfer of ownership from the taxpayer to the purchaser, and therefore, that the sale and lease have legal substance and cannot be ignored. The mere fact that the taxpayer simultaneously leased the premises from the purchaser does not make this a financing transaction. The purchaser now holds legal title to the property, and therefore, there has been a disposition for purposes of the investment credit recapture.

## **2. Penalties**

Taxpayer has requested an abatement of Section 1005 penalties due to reasonable cause. Section 1005 of the Illinois Income Tax Act provides that:

...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. See, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

As to the Section 1005 penalty for the years at issue, taxpayer's position on its tax returns was that the sales-leasebacks were not dispositions triggering recapture. While I disagree with taxpayer's position, since Illinois law is silent on whether a sale-leaseback is a disposition, and



federal tax law provides that recapture is not required where there is a sale-leaseback, taxpayer's position was taken in good faith. Further, taxpayer sought the opinion of a tax attorney on this issue, and the Department of Revenue stipulated that XYZ sought the advice of competent counsel on this issue. Federal case law has found reasonable cause where a taxpayer has shown he reasonably relied on the advice of an accountant or attorney. See Vorshek v. Commissioner, 933 F.2d 757 (9th Cir.) cert. denied 112 S. Ct. 591 (1991); Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990). See also U.S. v. Boyle, 469 U.S. 241 (1985).

Based on the above, I find that taxpayer has offered reasonable cause to abate the Section 1005 penalty.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized as to the recapture of the ABC investment tax credit and disallowed as to the credit card bank issue. Regarding the investment tax credit issue, the taxpayer has offered sufficient evidence of reasonable cause to abate the Section 1005 penalties.

As to the increase to taxable income made by the Department by adding several adjustments listed on Schedule J, the inclusion of service charge income in the sales factor, and the disallowance of investment tax credits for various properties used in retailing, the Notice of Deficiency should be modified in accordance with the stipulation of the parties.

Further, by stipulation of the parties, the XYZ FUNDING and XYZ CREDIT CORP. issues are resolved on the same basis as the settlement in the Sangamon County case.

Date:

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Linda K. Cliffel  
Administrative Law Judge

